



## REMUNERATION AND INCENTIVES BRIEFING

### EUROPEAN COMMISSION FORGES AHEAD WITH BONUS CAP FOR ALL CRDIV FIRMS

The European Commission has published proposed amendments to the remuneration requirements of CRDIV which would have the effect of extending the cap on variable remuneration (the "bonus cap") to all CRDIV firms, including smaller banks and all CRDIV investment firms.

In addition, the proposal would limit the firms which are able to disapply the "Pay Out Process Rules" (requiring deferral and payment in instruments), a change which could primarily affect UK banks with assets of between €5bn and £15bn, as well as materially limiting the ability for firms to waive those requirements in respect of relatively lower paid staff.

Therefore, although the European Commission's (the "Commission") proposals are billed as amendments to exempt smaller firms from certain of the more onerous remuneration requirements, the proposals would have the opposite effect in the UK.

The Commission's proposal is the start of the legislative process, the outcome of which is not likely to apply before the performance year commencing 1 January 2018 (and so the 2019 bonus round) at the earliest. The impact on firms in the UK is also dependent on the outcome of Brexit.

The Commission's proposal comes as part of a wider set of proposed updates to CRDIV and is available [here](#).

The principle underpinning the Commission's proposal on the remuneration requirements is that, contrary to the interpretation of CEBS (the predecessor-entity to the European Banking Authority) and of local regulators (including the PRA and the FCA), the "proportionality principle" should not permit any of the remuneration requirements to be disapplied in their entirety.

The EBA has already stated that this is its view of the current provisions, and updated its guidelines in December 2015 to confirm that it does not consider that the bonus cap is capable of being disapplied. In the UK, however, the FCA and PRA declined to follow the EBA guidelines on this point, and so currently UK CRDIV firms in Proportionality Level 3 are permitted to disapply both the bonus cap and the Pay Out Process Rules.

The Commission's proposals cover the following main areas:

- the bonus cap
- the Pay Out Process Rules
- the de minimis principle

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## 1. The Bonus Cap

One key effect of the Commission's proposal would be to clarify the CRDIV directive to make it absolutely clear that all CRDIV firms, irrespective of size or the nature of the firm's activities, would be required to apply the bonus cap, and so limit variable pay to 100% of fixed pay (or 200% with specific shareholder approval).

In the UK, this would potentially affect all investment firms that are subject to CRDIV, as well as banks and building societies, which are currently in Proportionality Level 3, given that these firms currently are permitted to disapply the bonus cap. Some of these firms will find that bonuses are rarely paid at more than 200% of fixed pay, whilst other firms may be materially affected by this proposal.

It is unlikely that the Commission's proposal could apply until the 2019 bonus round at the earliest, and whilst this is two years' off, some firms will need to start considering the impact on their remuneration structures soon to allow time to develop and communicate any required changes. This planning process is made all the more complex due to the uncertainty over Brexit.

For investment firms, the position is further complicated by a separate proposal being considered by the Commission, which could take many investment firms out of scope of the CRDIV remuneration regime all together. It is unfortunate that the Commission has not linked the two proposals, and its failure to do so is likely to create additional complexity and confusion whilst these proposals are progressed.

## 2. The Pay Out Process Rules

The Commission's proposal defines a specific exemption to the Pay Out Process Rules, which would replace to a great extent the PRA and FCA's existing approach to proportionality as implemented through the three Proportionality Levels.

The Commission's proposal is that firms with total assets (averaged over a four year period) of less than €5 billion could disapply the Pay Out Process Rules. This would leave UK firms with assets of between €5 billion and £15 billion, which are currently able to disapply these provisions as a result of falling within Proportionality Level 3, becoming subject to the full Pay Out Process Rules. UK banks in this position, in particular, should therefore consider this aspect of the Commission's proposals.

An additional consideration in the UK is that the PRA has imposed deferral requirements that go beyond the minimum required under the CRDIV remuneration rules (in particular, requiring deferral over up to 7 years, rather than 5). The PRA would need to consider whether it would apply those additional PRA-imposed requirements to all of the banks which would be brought within scope of the Pay Out Process Rules by the Commission's proposal, or allow such banks to apply only the lesser requirements imposed by CRDIV.

### Impact on Investment Firms

The Commission is in the process of considering proposals to amend the scope of CRDIV, which could potentially take some investment firms outside of the scope of CRDIV to instead become subject to a new (as yet undefined) prudential regulatory regime. The Commission is required to liaise with the EBA in this regard, and most recently, on 4 November 2016, the EBA published a Discussion Paper (available [here](#)).

In the November 2016 Discussion Paper, the EBA specifically addresses the CRDIV remuneration regime. The EBA states: "**The compliance related requirements of MiFID I, which are reinforced by MiFID II, should continue to apply to all investment firms.... Only "systemic bank-like" investment firms should continue to also be subject to the [CRDIV] provisions.**"

The EBA goes on to say that the "systemic bank-like" investment firms that would remain subject to the CRDIV remuneration provisions should also benefit from "future waivers", which have now taken shape in the Commission's proposed exemption from the Pay Out Process Rules (but not the bonus cap) as discussed in this briefing.

Therefore, if the Commission's CRDIV proposal, as well as the proposals set out in the EBA Discussion Paper, were both implemented, the result would be:

- All banks and building societies and "systemic bank-like" investment firms would be subject to the bonus cap and the Pay Out Process Rules (save that the Pay Out Process Rules could be disapplied by firms with total assets of less than €5 billion).
- Non-systemic investment firms would not be subject to the bonus cap.
- Non-systemic investment firms which are AIFMs or UCITS management companies would remain subject to the AIFMD and/or UCITS V remuneration regimes (which include equivalent Pay Out Process Rules), but other investment firms would be subject only to the MiFID remuneration rules (which do not include the Pay Out Process Rules).

The Commission and the EBA's proposals on the future scope of CRDIV for investment firms are therefore also a critical piece of the jigsaw for investment firms, and it is unfortunate that the Commission seems to be progressing the two aspects separately.

### 3. The de minimis principle

For those UK firms (currently those in Proportionality Levels 1 and 2) that are required to apply the Pay Out Process Rules, the FCA and PRA currently permit such requirements to be disapplied on an individual basis where the relevant staff member has total remuneration of less than £500,000 and variable remuneration of no more than 33% of total remuneration.

The Commission's proposal would replace this principle (which is generally referred to as the "de minimis principle") with a European-wide principle which would only apply where the staff member's variable remuneration is less than €50,000 and represents less than 25% of total remuneration.

This amended de minimis principle would potentially mean that a far greater number of relatively lower paid staff would become subject to the Pay Out Process Rules, and could create a material administrative burden, given that this could result in variable remuneration of relatively small amounts having to be deferred and paid in multiple tranches split between cash and instruments.

### 4. Other amendments

The Commission's proposal include an amendment to the text of CRDIV relating to the payment of deferred remuneration in the form of phantom shares (or "share-linked instruments") for listed firms but as this approach is already permitted in the UK this is not a material amendment for UK firms.

The Commission has also proposed deleting the statement that firms are required to apply the CRDIV remuneration requirements at a "group, parent company and subsidiary level". No context is given for this change, but it appears that this is a "tidy-up", given that this phrase has historically caused confusion. The EBA's view, which is clear from recent publications, is that firms are required to apply the remuneration requirements on a solo basis as well as on a consolidated basis (so that the consolidating institution must ensure that the rules are applied across the consolidation group, as well as with each CRDIV firm within the consolidation group also applying the rules on a solo basis). The reference to the rules being applied on a "group, parent company and subsidiary level" has always cut across this principle, and it seems that this is now being rectified. As such, this amendment too would not have a material impact in practice.

## Brexit

The complexities in considering the impact of the Commission's proposal (and, for investment firms, the potentially changing landscape of CRDIV) are further complicated by the uncertainties surrounding Brexit.

Whilst possible, it is by no means clear whether the European legislative process to implement the Commission's proposals could be completed before Brexit becomes effective. It is also unclear whether, following Brexit, UK firms will be outside of the scope of the CRDIV regime or whether the CRDIV regime would continue to apply notwithstanding Brexit (for example, should the UK remain part of the single market). The position may also differ in the shorter term if the UK agrees a transitional period following Brexit (such as a time-limited membership of the single market).

Finally, even if UK firms fall outside the scope of CRDIV after Brexit, the UK Government could opt to replicate the same, or similar, arrangements into UK law.

Taken together, therefore, it would seem that firms should continue to plan on the basis that they will be subject to the CRDIV remuneration provisions for the foreseeable future, and so this includes needing to carefully consider the potential impact of the Commission's proposal.

## 5. Next Steps

The Commission's proposal is, currently, just that, and will need to go through the full European legislative process before it becomes effective. It currently appears that, if enacted, the amendments could not become effective before the 2018 performance year (and so the 2019 bonus round) at the earliest, but this timing will need to be kept under review through out the process.

As discussed above, notwithstanding the various uncertainties, including as to Brexit, firms should consider whether the proposals could have a material impact on their business and, if so, start a process of monitoring developments and, before too long, considering what action might be needed to amend remuneration structures to comply.

We would be very happy to discuss the impact of the proposals on your firm in more detail.

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